

# The PERAC Financial Bulletin

Financial Market Review, Third Quarter 2006



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The summer of 2006 brought a lot of much-needed sunshine to investors as every major asset class posted positive returns during the third quarter.

As the quarter began, US stock prices were flirting with their lows for the year and long-term interest rates were close to recent highs, but the Federal Reserve's decision in early August to pause its two-year monetary tightening program sparked rallies in both equities and bonds. The trend toward declining interest rates, and its accompanying positive effect on stock market psychology, was also buoyed by significant price declines in oil and other commodities.

### The Equity Market

The S&P 500 Index rallied 8% from its July lows to finish the quarter up 5.2% and 7.0% year-to-date in price. (The accompanying table gives total return performance, including dividends, for this and all other indices.) Although the Dow Jones Industrial

Average was approaching an all-time high as the quarter ended (and it did pierce its March 2000 record on October 3), the more broadly based S&P 500, while up over 70% from its 2002 low, remained 15% below its record high. The NASDAQ Composite recovered from a brutal second quarter, but it still trails the S&P 500 by a significant margin year-to-date and remains nearly 60% below its peak reached during the 2000 bubble. In one of the quarter's most notable developments, mid-caps and small caps both lagged large caps by significant margins during the quarter, although the S&P 500 and Russell 2000 are about even year-to-date on a total return basis. Besides having become more attractive by several valuation measures, large caps typically do better when economic expansions enter a mature phase.

While the decade-long dominance of small caps over large caps appeared to be winding down, value stocks continue to outperform growth

stocks in all capitalization categories, both for the quarter and for the first nine months of the year.

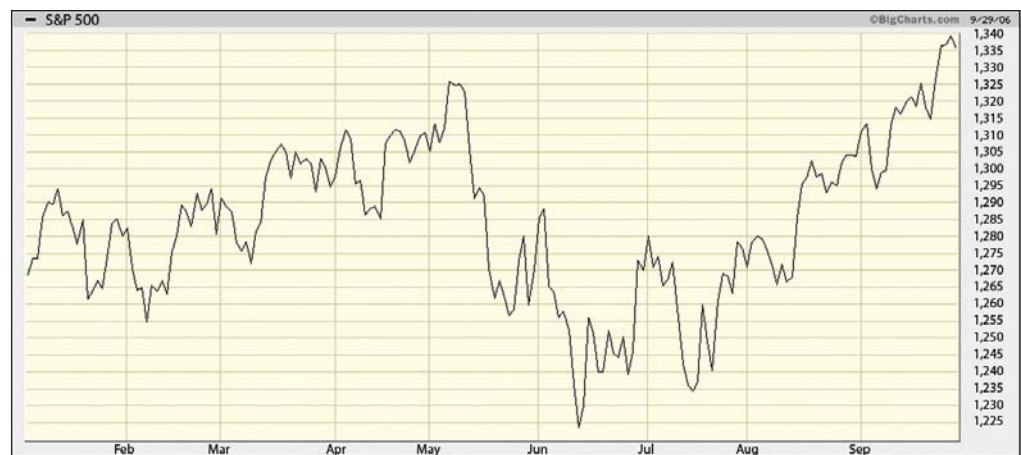
Among the S&P 500's ten industrial sectors, health care (+9.8%) and telecommunications (+9.6%) performed the best, while energy (-2.1%) and materials (-1.1%) lagged. For the year, however, energy (+10.4%) still remains the second best performing sector behind telecom (+22.6%). Among notable major industrial stocks, General Motors (+71%) is the surprising leader through the first three quarters, followed by AT&T (+33%), Merck (+31%), Walt Disney (+29%), and Hewlett Packard (+28%). Alcoa, 3M, and AIG are among the major stocks suffering negative returns so far in 2006.

International equity markets were also boosted by the Fed's new stance, which reduced fears of a US economic "hard landing". Continued rapid growth in China and corporate restructuring in Europe have also

### Chart 1

S&P 500, 2006: After a Spring Swoon, a Rising Trend

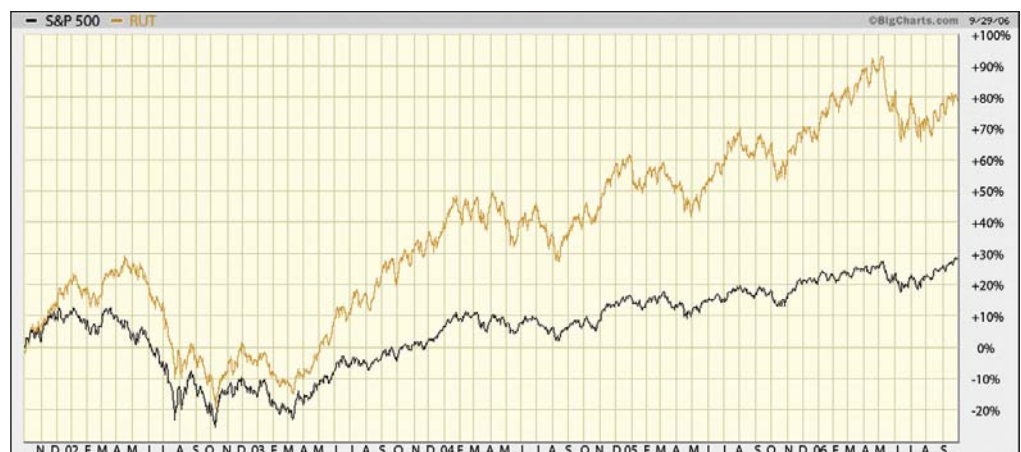
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### Chart 2

S&P 500 vs Russell 2000: Over Five Years, Small Caps Rule

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been positive factors. After closely mirroring the US stock rally during the third quarter, the MSCI-EAFE Index is up almost 14.5% in dollar terms for the year, with most of the incremental return over the US market coming from currency translation as a result of the general weakness of the dollar versus developed market currencies. Emerging markets recovered from their second quarter weakness and have an impressive year-to-date return of 12.4% in dollar terms.

### The Bond Market

Bonds generally provided positive returns similar to those of stocks during the third quarter as the market reacted favorably to the Fed's neutral stance at both its August 8 and September 20 meetings. Prior to these meetings, the central bank had raised the federal funds rate at seventeen consecutive meetings. After reaching a four-year high of 5.25% on June 25, the benchmark 10-year Treasury bond yield began the third quarter at 5.15% and finished at 4.64%. The yield curve

maintained an unusual negative slope as the Federal Funds rate remained at 5.25%, 3-month Treasury bills were at 4.9%, and 2-year Treasury notes were at 4.7% at quarter-end. Yield on both corporate bonds and mortgage-backed bonds also declined during the quarter. Since the market values of existing bonds rise when interest rates fall, the fixed income market saw capital appreciation as the Lehman Brothers Aggregate Index rose 3.8% for the quarter, bringing its performance back into positive territory (+3.1%) for the year. The high yield market has also done well, outperforming most investment grade sectors.

### Other Asset Classes

In contrast to the residential home market, the commercial real estate market has continued strong. Despite predictions of an overdue correction, publicly-traded real estate investment trusts rose another 9.3% during the quarter and are up over 23% for the year. Privately held real estate was appreciating at an annual-

ized rate of almost 19% through the second quarter. Industrial space and hotel properties were performing the best, while apartments and retail space were lagging. Among regions, the west has been the best and the Midwest has underperformed.

When they are ultimately reported, returns from private equity and venture capital are likely to be positive but unspectacular. Despite the equity market's recovery during the third quarter, the market for initial public offerings remained weak. During the quarter, less than half as many issues came to market compared to the number in the third quarter in 2005. Industry professionals are hopeful that stable interest rates and healthy economic growth, along with a robust mergers and acquisitions market, will bode well for future returns.

For hedge funds, the quarter was definitely a mixed bag. Overall year-to-date composite reported returns are in the mid to high single digits,

### Chart 3

S&P 500: Ten Year Perspective:  
Stocks Still Below Their 2000 Peak

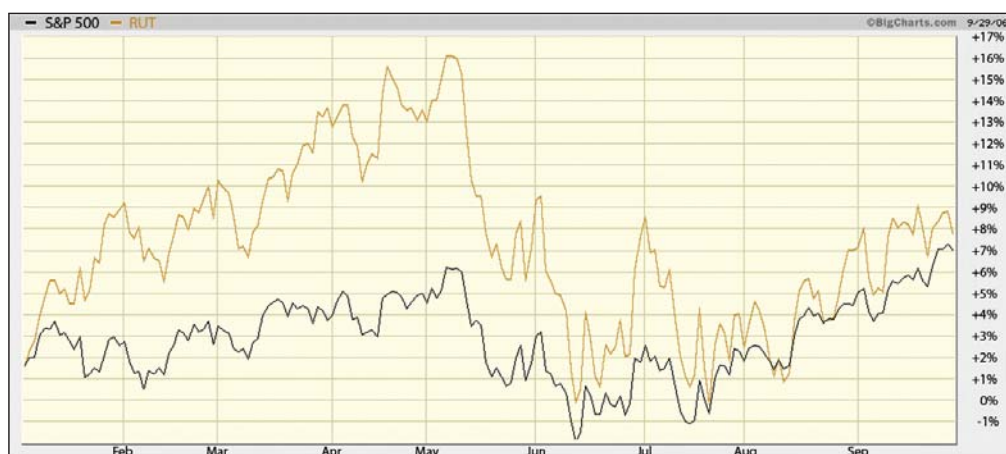
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### Chart 4

2006: Small Caps Fall From Peak,  
Large Caps Trend Up

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but the spectacular collapse of the \$9.2 billion Amaranth Advisors multi-strategy hedge fund, which suddenly lost about two thirds of its assets in late September as a result of speculative energy trading that went awry, cast a major pall. Furthermore, many observers feel that a consolidation of the industry is at hand as more and more new funds fail to achieve viable asset size and many well established funds are finding it difficult to produce the level of returns their investors expect. The Amaranth debacle is dramatic proof that, as far as hedge funds are concerned, there is no such thing as too much diversification.

If the third quarter's favorable market trends continue into the fourth quarter, most Massachusetts public retirement systems should have a reasonable chance of achieving their targeted rates of return this year. As always, however, there is uncertainty as interest rates may not have much further to decline and stocks, after a four year upward trend, are not historically cheap at current levels. Also, if energy and commodity costs reverse their recent sharp declines, inflationary pressures could re-emerge. Perhaps most importantly, economic growth has slowed, but only time will

tell whether the Federal Reserve will succeed in its effort to engineer a "soft landing" for the economy so that it slows enough to temper inflationary pressures but does not fall into a recession. Thus, retirement boards must continue to be vigilant to assure that their portfolios are as diversified as possible and that all managers are being closely monitored for performance and organizational issues. As always, the PERAC Investment Unit is available to offer advice and technical assistance to retirement boards in any aspect of their investment programs.

## TOTAL RETURNS | THIRD QUARTER, 2006

| INDEX   | THIRD<br>QUARTER<br>2006 | NINE<br>MONTHS<br>2006  |
|---|--------------------------|-------------------------|
| <b>US EQUITY MARKET</b>                       |                          |                         |
| Dow Jones Industrial Avg.                     | + 5.35%                  | + 10.85%                |
| Standard & Poor's 500 (Large Cap)             | + 5.67%                  | + 8.53%                 |
| NASDAQ Composite                              | + 4.00%                  | + 2.41%                 |
| Wilshire 5000 (Broad Market)                  | + 4.31%                  | + 7.97%                 |
| Standard & Poor's Mid-Cap 400                 | -1.08%                   | + 2.52%                 |
| Russell 2000 (Small Cap.)                     | + 0.44%                  | + 8.69%                 |
| <b>GROWTH VS. VALUE</b>                       |                          |                         |
| Russell 1000 (Large Cap) Growth               | + 3.94%                  | + 2.97%                 |
| Russell 1000 (Large Cap) Value                | + 6.22%                  | + 13.19%                |
| Russell Midcap Growth                         | + 0.89%                  | + 3.47%                 |
| Russell Midcap Value                          | + 3.53%                  | + 10.79%                |
| Russell 2000 Growth                           | -1.76%                   | + 4.21%                 |
| Russell 2000 Value                            | + 2.55%                  | + 13.26%                |
| <b>INTERNATIONAL EQUITY</b>                   |                          |                         |
| M.S.C.I. - E.A.F.E.                           | + 3.93%                  | + 14.49%                |
| M.S.C.I. - Emerging Markets                   | + 4.88%                  | + 12.39%                |
| <b>FIXED INCOME</b>                           |                          |                         |
| Lehman Brothers Aggregate Index               | + 3.81%                  | + 3.06%                 |
| Merrill Lynch High Yield Index                | + 4.05%                  | + 7.25%                 |
| <b>REAL ESTATE</b>                            |                          |                         |
| NAREIT - Equity Real Estate Investment Trusts | + 9.27%                  | + 23.38%                |
| NCREIF Property Index                         | + 4.01%                  | + 18.67%                |
|   | (Q2)                     | (Trailing<br>12 months) |